

The Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

17 June 2015

Dear David

**Re: Impact assessment of UNC modifications 0501V, 0501AV, 0501BV and 0501CV
'Treatment of Existing Entry Capacity Rights at the Bacton ASEP to comply with
EU Capacity Regulations'**

South Hook Gas welcomes the opportunity to respond to the impact assessment ('IA').

In our response to the UNC modification report, we recommended that Mod 501AV should be implemented and none of the findings or observations set out in the IA have caused us to alter this opinion.

In common with the structure of the IA, we have set out our thoughts on the various, key impacts identified by Ofgem, as follows:

Competition impacts

Potential impact on the TO Commodity Charge

The quantitative analysis aids understanding of the materiality of hand-backs, albeit based on assumed levels of hand-back. Perhaps most telling, is under the most extreme and least likely scenario, the cost of hand-backs to the industry would equate to a 2.76% average increase in TO Commodity charges. It would be difficult to argue that this is material and is counter to the conclusion reached by Ofgem, that it would have any affects on competition or efficiencies. An examination of charges between April 2014 and April 2015 show that TO commodity rates increased by 51.85% and there is no evidence to suggest that competition was undermined in any way. Using one measure of competition; liquidity on the OCM, ICE Endex has reported that trading volumes on the OCM have remained reasonably flat over this period.

On the basis of this evidence we do not agree with Ofgem that the three 'hand back mods' would have a negative impact on competition in the wholesale market.



Ofgem also suggests that there could be a deleterious impact on security of supply as a result of hand backs. Again, there is no evidence to support such a claim. Commodity charges are “socialized” meaning that all gas entering into the NTS is subject to the same level of charge. Based on historical flow information published by National Grid, there is no apparent change in flow behaviour following more significant increases in TO commodity rates compared to those stated in Ofgem’s quantitative analysis.

Potential impacts on transaction costs

Ofgem’s claim that an increase in the rate of the TO commodity charge could affect the ability for new entrants to enter the market and supply gas to the NTS can only be viewed as a hypothesis which is not supported by empirical evidence. Again, on examination of flow data published by National Grid there does not appear to be any relationship between commodity charge rates and supply volumes.

The suggestion that hand backs would necessarily lead to increased costs at the interconnectors and by extension, inhibit imports, is particularly surprising given Ofgem’s observations regarding capacity purchasing strategies it provides later on in the IA. Ofgem notes that Bacton is unconstrained and as a result Users are, and would be able to, purchase daily capacity products at a zero price. Assuming this assumption is correct, which is not certain in the medium to longer term, then the increase in the socialized TO commodity charge, or certainly that impacted by hand backs, would be lower than the level of the rebate received by those handing back their capacity (assuming that the Users have purchased a volume of capacity to support imports and are rational in their decision to offer capacity for hand back). On this basis, the total transaction cost at the Interconnector would be lower following hand backs, than otherwise.

On this basis, we do not believe that Ofgem has proved its hypothesis that security of supply could be compromised by hand backs.

Potential impacts of reduced flexibility

Ofgem recognises that the restriction in flexibility of use of Bacton capacity is a result of its decision to split the ASEP, rather than as a result of the mod proposals themselves.

Based on current flow levels compared to available capacity, Ofgem believes that flexibility is not a significant problem, although it does note that of all of the proposals, Mod 501CV would eradicate any problems, should they arise. In order to support the statement that any reduction in flexibility is likely to have a marginal impact, Ofgem sets out a number of capacity scenarios. In scenario 1, Ofgem states in the event that a User has capacity at the UKCS which it wishes to use at the IP, it can achieve this

through the purchase of interruptible capacity at the IP. Ofgem suggests that the probability of interruption is likely to be low, however, it fails to recognize the following:

- There is no certainty that, in future, there will be “excess” capacity at the Bacton ASEPs; and
- The fact that a User holding capacity at one ASEP effectively frees up interruptible capacity at another, does not maintain the flexibility for the capacity holder alone. Firstly, the interruptible capacity can be accessed by any User, which in turn will increase the probability of interruption and secondly, any such User would be ‘free-riding’ on the flexibility originally acquired by the holding User.

On this basis, we believe that Ofgem has undervalued the flexibility acquired by the holding User. It cannot, and should not predict future capacity holdings at the ASEPs and it fails to recognize the free-rider effects which characterize Mods 501, 501VA and 501VB.

We also note that Ofgem has failed to recognize the commercial drivers which underpin decisions to acquire long term capacity. At Bacton, as at other entry points, Users have purchased long term capacity, even when available volumes have suggested that it could be obtained on a daily basis, free of charge. Ofgem’s recommendations that Users are able to acquire interruptible capacity, does not chime with historical purchase behaviour. In order to ascertain the real value of entry capacity (including flexibility), Ofgem should look further than simply hypothesizing around forecasts of future flows, bookings and purchase strategies.

Potential impacts on long term bookings

Ofgem claims that it has not received any evidence that any of the four proposals would impact long term bookings. We would argue that the obtainment of any such evidence would be difficult, however, it must be the case that any change to the regulatory regime which alters the basis on which a contract was originally entered into will undermine confidence in the market and in particular the product where the change is most keenly felt. It is our view, that the split of the Bacton entry point and the allocation processes proposed in mods 501V and 501VA would undermine confidence in the long term capacity product. Further, and in any case, based on our views expressed in this response, we can find little evidence to support many of the conclusions arrived at by Ofgem.

Potential impacts on consumers

We note in an earlier section that we do not believe that there will be any detrimental impacts on the wholesale market if hand backs were to be permitted. Regarding the

more general point around the validity of hand backs, as we have stated previously in our response to the modification report, it is our contention that the Bacton split has the potential to undermine the fundamental rights and characteristics assigned to that capacity at the time it was purchased.

Yours sincerely



Jeff Mannering
South Hook Gas Company Ltd.

